THE EXCHANGE RATE

What Controls It?

With the compliments
of

THE CANADIAN BANK
OF COMMERCE

Established 1867

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FOREWORD

THE following series was published in the press of the larger Canadian cities, in the hope of bringing about a more general understanding of a complicated problem.

No claim is made that the explanation given is complete, as the topic is one on which volumes could be, and have been, written, but most of the principal factors that influence the Exchange rate have been covered.

It was felt that a summary of the problem, free from technical terms, would be of general interest to Canadians and, by the favorable reception given to the series, the belief seems justified.

October, 1920.

THE EXCHANGE RATE

III.—What Controls It?

IN No. II. of this series we explained why foreign dollars in a banker's hands are merely an evidence of indebtedness, a commodity to be bought or sold.

In order to make use of the credit these represent, he must first exchange them for the currency of his own country and this he does by sending them to a bank in the country in which they were issued. This means not only the labor of counting and sealing the parcel, but the cost of postage and the premium for insuring it against loss on the way.

The Bank to which he sends it must either remit payment for the foreign dollars in gold (the intrinsic value of pure gold being equal in all countries) paying express charges and insurance on the parcel, or if the bank has a credit balance in the country from which the foreign dollars came, it may give a cheque against that balance to the sending banker.

It was to avoid this cumbersome, risky and unsatisfactory way of settling international debts by the transfer of gold that the system of Bills of Exchange was brought into use, and we will try to explain that system next week.

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Capital Paid up $15,000,000
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THE EXCHANGE RATE

IV.—What Controls It?

IN No. II. of this series, we explained why the foreign dollar is a commodity and not money, and in No. III. the inconvenience of settling international debts in gold, which led to the system of Bills of Exchange described below.

Sales of exported goods are usually settled for by the vendor drawing a draft on the purchaser for the sum due, which draft the vendor deposits in his bank.

His banker forwards the draft (in such a transaction called a Bill of Exchange) to the nearest money market, probably, in the case of an American, to New York, Chicago or San Francisco, and in the case of a Canadian to Toronto or Montreal. To do this it is not necessary for him to insure his letter or even to register it, for if the bill were lost, he could get a duplicate.

For instance, if the vendor lives in the United States, he will offer the Bill of Exchange for sale, say, in New York, as Canadian funds, because the draft is payable in Canada.

There may be several persons in the market who want to buy Canadian money to pay for goods bought from us. If there are many such persons and only a few drafts on Canada are being offered, the bidding is keen and the price obtainable for the draft goes up.

If, however, there are few bidders and many drafts, the holders of the drafts may be willing to lower the price they ask in order to obtain their money at once.

This brings us to the influence of the balance of trade on the rate of exchange. We will deal with this aspect of the subject next week in No. V. of the series.

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THE EXCHANGE RATE

V.—What Controls It?

THE previous numbers of this series explained that the foreign dollar is not money but a commodity, and that the inconvenience of settling international debts in gold has led to the use of Bills of Exchange. We now come to the effect of the Trade Balance on the exchange value of the dollar.

If we bought from the United States goods to exactly the same value as those we sold to them, broadly speaking, there would be no exchange problem between us, since the amount of Bills of Exchange offered for sale in each country would just cover the requirements of those wanting to pay debts in the other.

At present, however, we are buying from the United States far more than they are from us. In consequence many Bills of Exchange, representing Canadian dollars, are being offered in the money markets of the United States by American vendors and few bids are being made for them. The holders, to dispose of them, lower the price until they become a tempting bargain. The Canadian dollars are therefore at a discount in the United States.

On the other hand, only comparatively few United States dollar Bills of Exchange, created by the sale of Canadian goods, are being offered in Canada and there are many bidders who want to buy them to pay their debts in the United States. In consequence the competition is keen, the price rises and United States dollars are at a premium here.

We will deal next week in No. VI. with the effect on the exchange rate of one result of war financing, namely the Inflation of the Currency.

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THE EXCHANGE RATE

VI.—What Controls It?

WE have already dealt with the principal Trade factors governing the Exchange Rate, and we now come to the influence of the Inflation of the Currency.

Before the great war, it was universally accepted that a paper currency should have behind it a very substantial gold (or silver) reserve. The purpose of this reserve was to admit of the redemption of paper currency on demand.

One method of war financing adopted by the belligerents was to increase their note issues without a corresponding increase in the reserves of gold. Redemption in full of the paper currency, therefore, became impossible. To retain the gold reserves then existing, these Governments refused, until the return of settled conditions, to redeem in gold any notes which they issued.

Canada made less use of this method than most of the belligerent countries, but the percentage of notes issued against the amount of the gold reserve held has risen considerably.

In the United States, the proportion of notes issued to reserve held did not rise to the same extent, and the comparison is one of the factors in the world valuation of our respective currencies.

Next week in article No. VII. we will deal with a second war measure which has had an important effect on the Exchange Rate, namely, the Restriction on the Export of Gold.

THE EXCHANGE RATE

VII.—What Controls It?

WE have shown in former issues of this series that currencies, outside their own countries, are commodities, not money; the advantage of Bills of Exchange over gold for making settlements and the effect of the Trade Balance on the Exchange Rate. In our last article, we explained the influence of the Inflation of the Currency. We will now deal with the effect of the second of the War Finance measures, the Restriction of the Export of Gold.

Before the War, except during the greatest financial crises, paper currencies of the chief countries could be redeemed in gold on demand, and the gold could be sent to another country.

The fact that this was possible had great controlling influence on fluctuations in exchange, for when the premium on a Bill of Exchange on any country rose above the cost of shipping and insuring the gold, settlements were made by such shipments. Gold reserves, if depleted by shipments to countries where our paper money was at a discount, usually were restored by the purchase of gold in countries where our paper money was at a premium. The range of the rise and fall in exchange was thus kept within comparatively narrow limits.

When war broke out, however, all the belligerents prohibited the export of gold in order to retain as large reserves as possible for their future financing.

The principal controlling factor in the exchange market was therefore withdrawn, and the priceof Bills of Exchange depended chiefly on whether the amount offered exceeded, or was less than the demand.

In our next issue, a week from to-day, we shall touch upon some other influences on the exchange value of the dollar which, to keep the problem in its simplest form, have so far been omitted.

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THE EXCHANGE RATE

VIII.—What Controls It?

WE have attempted to show in this series the principal causes of variations in exchange rates.

In order to reduce the problem to its simplest form, we have not mentioned several factors which, in spite of adverse trade balances, had considerable influence in maintaining the value of our dollar abroad during pre-war days.

One of these was the great volume of Canadian securities (such as bonds of the Dominion and Provincial Governments, Municipalities and Companies), sold annually in other countries. The proceeds of these sales created balances to our credit abroad just as though we had exported an equal value of merchandise. At the present time our sales of securities abroad amount to far less than formerly owing to the "tightness" of money and the high interest rates demanded.

Another factor of importance, the influence of which it is difficult to estimate, is the amount of foreign money brought into Canada by immigrants and tourists.

An adverse Exchange Rate, especially one so great as ours with the United States, taxes heavily all users of imported goods. The greater the excess in the value of imports over exports, the higher the Exchange Rate is likely to become.

Those who import luxuries because they can afford to pay the additional tax, therefore, help to maintain the rate or even to raise it still further. Thus the price of imported necessities is increased to all, including many consumers who can ill afford the extra burden.

In our final article we shall summarize the methods by which the exchange rate may be brought back to normal.

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